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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 581.

No. 582.

ADOLPH B. SPRECKELS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONER.

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The respondent in his Brief and upon oral argument seeks to secure an affirmance of the action of the Circuit Court of Appeals in reversing the decision of the Board of Tax Appeals holding that petitioner was entitled to deduct as an ordinary and necessary business expense, commissions paid brokers on sales of stocks, bonds and other commodities on two grounds, one, that such deduction is avail-

able only to "dealers" by reason of uniform Treasury practice of many years' duration, and two, that petitioner's activities although found by the Board to constitute engaging in business, did not constitute a "trade" or "business" within the meaning of Section 23 (a) of the Revenue Act.

I. Sales Commissions as Deductible Expenses.

As pointed out in the Brief for Petitioner, the statute and regulations are clear that selling commissions are deductible as an ordinary and necessary expense of a business of buying and selling stocks, bonds and commodities for profit and but little can be added to what is there said. Respondent's claim of a long continued Treasury practice limiting such expense to dealers is based entirely on G. C. M. 15430, XIV-2 C. B. 59. This ruling was issued shortly after the amendment to the Regulations; consequent upon the adoption of the 1932 Act, and at a time when the right of a trader, as distinguished from a dealer, to the deduction was being litigated in the *Winmill* case (35 B. T. A. 804 and 93 Fed. (2d) 494). The *Winmill* case before the Board and the Circuit Court of Appeals involved both purchasing and selling commissions, the Court holding both deductible by a trader as a business expense. The Commissioner asked for certiorari only as to purchasing commissions and the decision of this Court is limited to a consideration of such commissions. If long-continued Treasury practice now warrants a denial of the right to deduct selling commissions, it is remarkable that the point was not urged to the Board or the Circuit Court of Appeals and even more remarkable that certiorari was not sought as to selling commissions also. Perhaps the Treasury practice was not sufficiently ancient and uniform at that time. In any event the alleged practice was not uniform in the sense that it applied to all "property."

The present Treasury interpretation received the approval of no court prior to the decision in the present proceeding. Since the doctrine announced in G. C. M. 15430

was, therefore at the time of its issuance, already under challenge, later sustained by the Circuit Court of Appeals for the Second Circuit in the *Winmill* and *Neuberger* cases, it is difficult to see how it can be relied upon as an authoritative interpretation limiting the express provision of the regulations making such commissions generally deductible as a business expense.

The regulations themselves are a negation of the existence of a Treasury practice such as is claimed respondent, since, with the reenactment of the 1932 Act, the regulations were changed, as noted in petitioner's brief and during oral argument, to exclude expressly from the former provision concerning the nondeductibility of sales commissions, such commissions as might be an ordinary and necessary expense of business.

G. C. M. 15430 is but a legal opinion of the Bureau's attorney, no more persuasive or controlling than the argument of counsel for respondent before this Court. A memorandum is incompetent as proof of Treasury practice. It is clearly hearsay and self serving. Had respondent intended to use long-continued Treasury practice as an authority to override the provisions of the law and regulations, he should have offered proof of such practice before the Board and asked a finding thereon.

In addition to relying upon G. C. M. 15430 as evidence of long-continued Treasury practice, respondent also relies upon it to establish that it is difficult, if not impossible, for a dealer in securities to match selling commissions with specific sales. This argument again assumes a fact not in evidence.

The regulations in Art. 22 (c)-5 define a dealer as a merchant of securities selling *directly to customers* and authorize such dealers to inventory their securities to determine gain or loss, a right denied to "taxpayers who buy and sell * * * securities for * * * speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business." Since a dealer must sell *directly to customers* to fall within the definition in the regulations, it

is difficult to see how he would have any selling commissions to pay. If he sells *through brokers*, he ceases to be a dealer within the definition. This again illustrates the impossibility of accepting a general counsel's memorandum as a substitute for testimony adduced at the hearing.

If, as contended on argument, the change in the regulations under the 1932 Act was merely a recognition of existing Treasury practice according dealers in securities the right to deduct selling commissions as a business expense, why was not an apt expression used to indicate that the exemption was limited to dealers rather than the phrase "when such commissions are not an ordinary and necessary business expense." Had the explicit limiting language been used, there would have been no occasion for a five page legal opinion to point out that the language actually used meant something other than what it says.

The use of a "net" selling price for computing gain or loss is not an established Treasury practice. For example, stamp taxes paid on the transfer of securities or commodities sold are deductible under section 23 (e) of the Revenue Act. This was done in the present case. R. 13-14, No. 581. If taxes necessarily paid in connection with a sale are not to be deducted in determining the amount received on sale, why should selling commissions be deducted when they are clearly an expense of doing business.

Nor does the holding in the *Union Pacific* case (293 U. S. 282) in anyway affect the determination of the present case. While it is true that the Court was there considering selling commissions and held that such commissions were "properly chargeable to capital account," the facts were that the *Union Pacific* was not seeking to deduct the commissions as the expense of a business of buying and selling bonds for profit, but to amortize such commissions over the life of the bonds (the company's own issue) as a cost of securing capital in the same category as bond discount. Obviously, the determination that such selling commissions are chargeable to capital account, can have no controlling value in the de-

termination of the right of a trader to deduct as a business expense, commissions paid on sales of bonds issued by others. In the case of the issuer, such commissions are a cost of securing capital and proper accounting practice requires their charge to capital account and their amortization over the life of the bond. In the case of a trader there is no "capital account" to which his *selling* commissions can be charged since the sale has closed the account.

Again it must be pointed out that the petitioner here was a trader in both securities and *commodities*, a situation ignored by respondent and upon which we have no evidence, even hearsay, of Treasury practice and not covered by any authority or rulings. Since the selling commissions related to sales of both securities and commodities and since there were no findings as to the amounts of each, nor evidence in the record brought to the Circuit Court of Appeals as to such segregation, that court should have affirmed the Board's decision if selling commissions upon commodities alone are deductible as a business expense, since the burden was upon the Commissioner before that court to show error in the record.

II. Trader in Securities and Commodities Engaged in Trade or Business Within the Meaning of Section 23 (a).

The first reaction to the respondent's second point is one of amazement that the argument would be advanced that a taxpayer commonly referred to as a *trader* is not engaged in a *trade* or business. However, in the present case, it is even more astounding that the argument is advanced for the first time in the proceeding before this court and upon the record brought up.

The Board found:

> "During the taxable years he (petitioner) maintained an office, with employees keeping complete sets of books, which were kept and the income tax returns were made upon the basis of cash receipts and disbursements. *Petitioner was engaged in the business of purchasing*

and selling stocks, bonds and commodities for profit. He paid to brokers selling commissions in connection with such sales as follows: In 1934, $23,692; in 1935, $2,246.25." No. 581, R. 24 (Emphasis supplied.)

The Board's opinion reads in part:

> "Are selling commissions paid by a trader in securities deductible as a business expense? * * * We hold therefore that the respondent upon this point is in error, and that the selling commissions are allowable deductions." No. 581, R. 26.

Respondent concedes that no point was made before the Board or the Circuit Court of Appeals that the activities of a trader, or of petitioner as trader did not constitute a trade or business. As clearly appears from the Board's opinion the only question presented was whether selling commissions are an expense of doing business. The Board made no finding of facts concerning petitioner's activities, but found that he was engaged in a business. Respondent cannot urge, as was done in *United States* v. *Pyne*, 313 U. S. 127, that the record showed that the Board in making its findings was unmindful of the definition of business approved by this court in the *Higgins* v. *Commissioner*, 312 U. S. 212, involving an investor's expenses, and the *City Bank Farmers Trust Company* v. *Helvering*, 313 U. S. 121, involving executor's expenses, since the Board had decided both of those cases prior to its decision in the *Spreckels* case and the action of this Court was to affirm the Board's definition.

Respondent must also concede that the question was waived before the Board since in his opening brief to that body, under the heading: "Respondent's Request For Findings of Fact" he says:

> "Upon the evidence, the respondent respectfully requests that the Board make the following findings of fact:

* * * * * * *

"3. During the calendar years 1934 and 1935, petitioner was engaged in the business of purchasing and selling stocks, bonds and commodities for profit, and during the calendar year 1934 paid selling commissions in connection with such sales amounting to $23,909.29, and for the year 1935 selling commissions amounting to $2,363.75. The selling commissions so paid were not taken as a deduction in computing petitioner's income tax for the years 1934 and 1935."

Respondent can scarcely expect this Court, at this late date, to permit him to argue that the Board should not have made a finding of fact he requested the Board to make.

Again, when the record on review was prepared, no suggestion was made that the point would be urged that petitioner's acivities did not amount to engaging in trade or business, (Assignments of Error R. 32-34, No. 582) nor was any attempt made to bring up the evidence before the Board: (Designation of Portions of Record, etc. R. 40-41, No. 582)

Had the point now urged been made, the evidence as well as the pleadings, findings and decision would have been brought up, including the respondent's request for the finding made, and the Circuit Court of Appeals could have considered whether the respondent was not precluded from making the point. It is submitted that in the record the question is not open for argument before this Court.

The present case is not one where it is sought to uphold the action of the Board on a theory not advanced before it, but rather to uphold the action of an appellate court *reversing* the Board's decision on a theory advanced neither to the Board nor to the appellate court. This is a step beyond the decision of this court in *Hormel* v. *Helvering*, 312 U. S. 552, where at least the new theory was argued before and relied upon by the Circuit Court of Appeals. If the exception be extended to the present situation, every record on appeal in the future, regardless of the specifications of error, must contain all the evidence taken and the arguments made before the trial court or Board. The rule to be

applied here is that announced in *Helvering* v. *Wood*, 309 U. S. 344, 348-349, where this court held that the Government having before the Circuit Court of Appeals, expressly waived any reliance upon a certain section of the revenue act, could not present before this Court, as a wholly new issue, the applicability of that section. See also: *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, 498, and *General Utilities & Operating Co.* v. *Helvering*, 296 U. S. 200, 206-207. The remarks of the Court in the *General Utilities* case show the futility of the respondent's suggestion that, as in the *Pyne* case, the present case may be remanded for further proceedings in order that petitioner may adduce additional evidence as to his activities. (Respondent's Brief page 12) *In effect the respondent is asking a remand by this Court in order that he may bring up the evidence upon which the Board made a finding as requested by him and permit him then to argue to this Court that such request should not have been granted.*

The *Pyne* case is not in point as to the proposition that the Board's finding that petitioner was engaged in business is not conclusive here, since in the *Pyne* case the Court of Claims made findings as to evidentiary matters and failed to make the general finding that taxpayer was carrying on a business. This Court, therefore, was able, on the record in the *Pyne* case, to determine that the executors were not "carrying on any trade or business."

This Court states in the *Higgins* case, 312 U. S. 212, 217:

> "To determine whether the activities of a taxpayer are 'carrying on a business,' requires an examination of the facts in each case."

Obviously it is the duty of the Board to make this examination and to make its conclusion therefrom, having done so, whether the conclusion be regarded as an ultimate finding of fact, or a mixed finding of law and fact, it is conclusive on appellate review, even when the evidence is preserved in the record, which was not done here. The failure of the

Court of Claims to make this ultimate finding clearly distinguishes the *Pyne* case.

Compare the long-established practice of this Court to refuse to consider on certificate from a Circuit Court of Appeals mixed questions of law and fact. *Pflueger* v. *Sherman*, 293 U. S. 55, 57-58 and authorities cited.

Even though all rules relating to the timeliness of respondent's second point were waived, he is still confronted with the proposition that he must argue that under no set of facts or circumstances can the activities of one engaged in buying and selling stocks, bonds *or* commodities for profit amount to a trade or business, for only under such circumstances can the question become one of law. There is absolutely nothing in the record justifying respondent's suggestion (page 12 of his brief) that petitioner was "managing his investments" or, if he were, that his buying and selling activities had anything to do with that management. Furthermore, since his business was *buying and selling* for profit, the possibility that he was buying for investment is negatived. Accordingly the decision in *Higgins* v. *Commissioner, supra*, with reference to investment expenses has no application. It should be noted however that, in the *Higgins* case, the Board held that the taxpayer's real estate activities amounted to a trade or business and that the expenses sought to be deducted should be prorated in order that the taxpayer might have the benefit of the portion allocable to the real estate business.

That a trader in securities is engaged in a trade or business, is directly held by the Circuit Court of Appeals for the Fourth Circuit in *Dart* v. *Commissioner*, 74 Fed. (2d) 845, 847, cited with approval in *Deputy* v. *Du Pont*, 308 U. S. 488, 495. Inasmuch as "traders" invariably hold themselves out to the world, for the sale of their property, by means of orders to their brokers, such "traders" also satisfy the requirements as to such "holding out" in the concurring opinion in that case.

The Commissioner does not seem to have questioned the Court's conclusion in that regard. The Circuit Court

of Appeals for the Second Circuit in *Winmill* v. *Commissioner*, 93 Fed. (2d) 494, 496, was considering the case of a trader, held that his activities would have justified a finding that he carried on his operations as a trade or business and saw no reason for discrimination between dealers and traders. The respondent himself in Article 22 (c)-5 of Regulations 86, defining a "dealer in securities" assumes that a taxpayer's activities in the buying and selling of securities for speculation may constitute "the carrying on of a trade or business."

The statutory provision authorizing the deduction of business expenses in no way limits the character or extent of the trades or businesses entitled to such deductions. The language of Section 23 (a) of the Revenue Act of 1934, authorizes the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *." (Emphasis supplied) In *Higgins* v. *Commissioner*, *supra*, this Court in describing the evolution of the phrase "carrying on any trade or business" says:

> "Since the first income tax act, the provisions authorizing business deductions have varied only slightly. The Revenue Act of 1913 allowed as a deduction 'the necessary expenses actually paid in carrying on any business.' *By 1918 the present form was fixed and has so continued.* No regulation has ever been promulgated which interprets the meaning of 'carrying on a business,' nor any rulings approved by the Secretary of the Treasury, i.e., Treasury Decisions. Certain rulings of less dignity, favorable to petitioner, appeared in individual cases but they are not determinative." (Emphasis ours)

Congressman Claude Kitchin, Chairman of the House Committee on Ways and Means, submitted the report to accompany the bill H. R. 12863, which became the Revenue Act of 1918. To explain to the House what was meant by the phrase "trade or business" as used for the first time in that Bill (Congressional Record, Volume 56, Appendix

Page 678, 65th Congress, 2nd Session), he said to the House:

> "Under the present act a loss to the taxpayer can only be deducted if it is connected with the transactions of the business, while a casual loss on the outside cannot be deducted. To illustrate, *suppose I am a player of the stock market, and that is my business.* Suppose I lose $50,000. I can deduct that from my total year's earnings. Say my total income is $100,000, and that I lost $50,000; but if I am a merchant, a farmer, or a lawyer, and happen to see something in the paper which makes me think I can make a big sum of money, and then I go out and buy a future contract, and make a loss of $10,000, I cannot deduct that from my income under the existing law or under the act of 1913. Suppose in my business as merchant, lawyer, or farmer I made $10,000. I would have to pay an income tax on that whole $10,000, although I had lost $10,000 in three days on a little side stock-exchange gamble that I had made. Now, this bill permits all taxpayers to deduct their losses that are made in their business or outside of their business during the year. If I make $10,000 in the practice of the law and lose $10,000 on the stock market I can deduct it because in the case I have supposed I would have no income left." (Emphasis ours)

Since the only example cited by the Chairman of the Committee on Ways and Means so aptly covers the situation of the present petitioner, and since no case can be found holding that the activities of a trader in securities or commodities is not a trade or business within the meaning of Section 23 (a), it seems unnecessary to cite further authority.

The Court is entitled to consider the explanation of Mr. Kitchin, under the doctrine that statements of those who had charge of the law made to the legislative body passing it as to its meaning and purpose are always competent. *Ex. Parte Farley*, 40 Fed. 66, 69.

United States v. *Wilson*, 58 Fed. 768, 771 (statements of Senator in charge of bill).

This rule as to competency includes "explanations * * * made by those engaged in helping to prepare and urge the enactment of the legislation." *Smith* v. *Gilliam*, 282 Fed. 628, 636.

In the recent case of *United States* v. *City and County of San Francisco*, 310 U. S. 16, 20, this Court gave extensive consideration to Congressional debates during the passage of the Hetch Hetchy Bill, stating they were competent as indicating, "a common understanding both on the part of the sponsors of the bill and its opponents."

This Court did not in the *Higgins* case announce a new definition of doing business, but merely affirmed the application to an invester of the rule announced by the Court in *Van Wart* v. *Commissioner*, 295 U. S. 112. It was held in that case that where under the facts, a ward under guardianship was not engaged in business, the guardianship as such was not a business or entitled to deduct certain attorneys fees. Certainly there is nothing in the *Van Wart* case, or any case based thereon, which would justify on the record before this Court, a reversal of the Board's conclusion that petitioner was engaged in a trade or business.

That neither Congress nor the Treasury is prepared to follow the *Higgins* case is indicated by the Conference Report 1203, accompanying H. R. 5417, 77 Congress, 1st Session, Amendment No. 41, page 12, reading as follows:

> "Amendment No. 41: This amendment amends section 23 (a) (1) of the Internal Revenue Code by inserting after the words 'taxable year' the words 'in conserving and conducting the business affairs of the taxpayer.' The conferees have deferred action on the merits of this amendment with the understanding that it will be considered in a later bill dealing with administrative matters. They were advised by the Treasury Department that wherever possible final decision by the Bureau of Internal Revenue on issues arising under the *Higgins* v. *Smith* (sic.) decision would be deferred pending such later legislation. The Senate recedes." (The case intended is *Higgins* v. *Commissioner*, 312 U. S. 212.)

We understand that similar relief is proposed in the 1942 amendments to the Revenue Act about to be proposed. Clearly under such circumstances there is no occasion for further restrictions on the meaning of trade or business as used in section 23 (a)-1.

The decision of the Circuit Court of Appeals is incorrect and should be reversed.

Respectfully submitted,

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